BILL # HB 2356

TITLE: corporate income tax; sales factor

SPONSOR: Huffman

STATUS: As Amended by House Ways and Means

REQUESTED BY: House

PREPARED BY: Tom Mikesell

	FISCAL YEAR		
	2003	**2004**	**2005**
REVENUES			
General Fund- Corporate Income Tax	$-0-	See Below	

FISCAL ANALYSIS

Description

The bill would allow companies to use a corporate income tax apportionment formula that places additional weight on sales, and less weight on property and payroll, or continue to use the current formula. This formula is used in calculating how much of the income of a multi-state company should be apportioned to Arizona. The current apportionment formula places 25% weight on a company's property factor, 25% weight on a company's payroll factor, and 50% weight on a company's sales factor. The bill would permit companies to calculate their liability based on an alternative formula that places a higher weight on sales. The sales weight in this alternative formula would gradually increase to 100% by Tax Year 2008. The initial apportionment changes included in the bill would become effective from and after December 31, 2003.

Estimated Impact

This bill would reduce corporate income tax revenue to the General Fund based on the revised apportionment formula. JLBC Staff, however, does not have access to the corporate taxpayer data needed to derive an independent estimate of the impact. The Department of Revenue (DOR) maintains taxpayer records, and has devised an estimate of the bill's impact. Based on DOR's analysis of taxpayer data from Tax Years (TY) 1995, 1996, and 1998, corporate liability could be reduced by as much as $20 million in TY 2004 and $100 million in TY 2008.

DOR believes that the effects of the revised formula will be phased in over time. Under this phase-in, corporate liability would be reduced by up to $5 million in FY 2004 and up to $23 million in FY 2005. While based on DOR's observations of past corporate tax adjustments, the phase in schedule is speculative. In addition, DOR's data is from the mid 1990's and they are currently attempting to update it.

While the bill would lead to a direct reduction in corporate tax liabilities, the revised apportionment formula would create a more favorable business environment. As a result, the bill could generate additional business activity that would lead to an offsetting increase in tax collections. This type of secondary, or dynamic impact, is difficult to estimate. The State of California has the most advanced state government level dynamic forecasting model. The California model estimates that a $1 billion reduction in Bank and Corporations Taxes would stimulate economic activity, leading to additional revenue in future years. Based on the model, these changes to the economy would be fully realized within 5 years, at which point the $1 billion direct tax reduction would be offset by approximately $180 million in additional state revenue.

<u>Apportionment Formulas</u>
Current law places twice as much weight on a company's sales factor as it does on its property and payroll factors. The term "factor" means the portion of a company's activity in Arizona divided by the company's activity everywhere. The current apportionment formula is displayed below:

$$\textbf{Current:}\quad \textbf{\% of Income Allocated to Arizona} = \frac{\textbf{(25 * Property Factor) + (25 * Payroll Factor) + (50 * Sales Factor)}}{\textbf{100}}$$

Analysis

The bill would gradually place even more weight on sales each year through FY 2008. The higher sales weighted formulas would benefit companies that own property in Arizona and employ local labor, but export their product. In FY 2004, the above formula would be modified to use a 60% weight on sales. The sales weight would increase to 70% in FY 2005, 80% in FY 2006, 90% in FY 2007 and 100% in FY 2008.

The JLBC Staff does not have access to detailed corporate tax records. DOR, however, estimates that based on historical tax collection data, allowing the option of choosing between the current apportionment formula or one that places a 100% weight on sales would have led to overall tax reductions of 22% to 26% in those tax years. For its analysis, DOR estimated that when fully annualized the total reduction in revenues for a tax year would be $100 million. This estimate assumes tax liability that is roughly equivalent to the corporate liability of $421 million in TY 1995, which DOR indicates is similar to current corporate income tax levels. Following the 5-year phase in schedule proposed by the bill as amended, this breaks down into 5 cumulative tax year reductions of $20 million.

The DOR analysis further breaks down the tax year impact into a fiscal year basis. The DOR analysis assumes that for each tax year change, 25% of the costs would be realized in the first fiscal year, 90% would be realized by the second fiscal year, and the full 100% would be realized by the third fiscal year. Using this approach, DOR estimates that tax collections would be reduced by $5 million in FY 2004 and by $23 million in FY 2005.

There are a number of concerns in directly translating historical tax data from 1995,1996, and 1998 into a cost estimate for FY 2004 and FY 2005. The following points should be considered:

- We do not know exactly when firms will start reducing their estimated payments. DOR's rule of thumb is that 25% of the cost will be realized by the first year, 90% will be realized by the second year, and the full 100% will be realized by the third year. This is speculative and is based DOR's observations of past corporate tax adjustments.
- The specific cost estimates provided by DOR do not include any potential behavioral impacts or "dynamic" benefits associated with a tax reduction on corporations. Beyond the direct impact from a loss in tax collections from the apportionment formula changes, a dynamic analysis would attempt to measure the impact of the tax law change on the overall economy. This tax law change would create a more favorable business environment for businesses that sell their product in other states. This could attract new businesses to locate in Arizona, though it may take some time for this to occur. Also, while taxes do affect business location decisions, other factors affect these decisions as well, including availability of skilled labor, transportation infrastructure, and proximity to manufacturing inputs. We are currently analyzing the dynamic implications of this tax change using third party models of the Arizona economy, but have not included any such impacts at this time in the interest of providing the direct fiscal impact in a timelier manner.

Local Government Impact

Each year local governments receive an amount equal to 15% of income tax collections from two years prior. The reductions in corporate income tax collections would result in a reduction in local government distributions in FY 2006 and later.

3/20/03